STARVINE CAPITAL
— CORPORATION —

Overview

- Price and Value: How do the Dots Connect?

October 20, 2017

Dear Starvine Capital Client:

In Q3 2017, accounts open and fully invested in the Starvine Flagship Strategy since the beginning of the quarter declined 6.6%, while the Mid-Large Cap Strategy declined 5.9%. Flagship still rests in positive territory on a year-to-date basis; Mid-Large Cap however was incepted in March of this year. During the quarter, the S&P TSX Total Return Index increased 3.7% and the S&P 500 Total Return Index increased 0.5% in Canadian dollars (+4.5% in USD). The weakening of the US dollar was the single largest headwind, given the heavy weighting of U.S. listed equities and the U.S. dollar's decline of 3.8% against the Canadian dollar. Three holdings in particular rolled back in August after reporting mixed earnings reports. However, the conclusion was reached in all cases that the market overreacted; subsequently, these positions were increased. Insiders bought stock on the open market in all three situations. On a separate note, CRH Medical was re-introduced to the strategies because its price, in my opinion, over-corrected to a cheap absolute valuation. Due to the confluence of a number of events (short seller report, adverse reimbursement rate news, and a 'messy' earnings report in August), investors and sell-side analysts seem to have abruptly lost confidence in the company. Despite the recent uncertainty surrounding CRH, the pillars of the original thesis still remain.

Outlook

As the 30 year anniversary for Black Monday elapses, the media has been focusing on the lofty trading levels of the markets. The indexes continue to tick up to fresh highs. Interestingly, this is happening in the seeming absence of widespread over-optimism. Certainly, the Starvine strategies were not beneficiaries of a rising market over the past quarter. The reality is that both strategies are concentrated, with 13 and 18 holdings for Flagship and Mid-Large Cap, respectively. If a few companies report off-quarters, which is what happened in August, near-term performance can be rocky. From a fundamental standpoint, however, one should not be perturbed. In fact, the weights of holdings that sold off most during the quarter were increased or refilled.

For the first six months of 2017, adjusted cash flow per share (CFPS) in the Flagship strategy increased over 18% vs. the same period in 2016, whereas for Mid-Large Cap strategy the growth was 22%. These averages are weighted based on the quarter-end market value of each holding. The growth in cash flows for the energy companies (100%+ growth for each year-over-year) were removed from the calculation as they can be seen as one-time events benefitting off a trough in the sector one year prior. If one were to further remove the strongest contributor (a high growth company), growth in CFPS would drop to 3% and 5% for the Flagship and Mid-Large Cap strategies, respectively. The above measurements are inherently lumpy due to the concentrated nature of both strategies; it is assumed in the calculations that each holding was held in the same proportion one year ago (which certainly was not the case due to rebalancing) so the measure is limited in its validity. It

can be viewed as a rough gauge, with a wide margin of error, for the collective growth of earnings power in the portfolios.

There is reason to believe the majority of stocks in both strategies are significantly undervalued; it is for this reason portfolio turnover has been relatively low this year – the expected return is high enough on most holdings that there is no compulsion to make big changes or find replacements.

Price and Value: How do the Dots Connect?

Last summer, I was chatting about stocks with a friend. This individual happens to be a full-time investor, and so it hit me when he asked the questions, "What connects price and value? Wouldn't it be interesting if someone could empirically show a connection between the two? Why should price travel to value?"

Those questions really struck me; they are basic, and yet not so easy to answer. How many of us who look for value all day have recently given those questions serious reflection? I, for one, have not given them much direct thought for many years. As an exercise, let us walk through the ABCs of value in plain English.

What is Value Investing?

There is the old saying that value investors aim to buy a dollar for fifty cents. If an investor had unlimited opportunities to buy a dollar for less than its face value, and furthermore had perfect certainty of being able to sell a dollar for one dollar, his wealth would grow exponentially without taking risk.

But let's first acknowledge the definitions of price and value as per the Merriam Webster dictionary:

> *Price: the amount of money given or set as consideration for the sale of a specified thing.*
>
> *Value: a numerical quantity that is assigned or is determined by calculation or measurement.*

So price is simply what one pays, or an amount that has been agree upon, while value is a number assigned that requires calculation or measurement. In other words, price could be anything, while value requires reasoning and facts.

Value investing is, in my words, the conscious practice of buying investments below their estimated value as can be determined by facts and a rational process. It makes inherent sense to buy a company at a steep discount to its fair value. By doing so, an investor creates a form of downside protection, while positioning for benefit to the upside. Ultimately, if we properly appreciate and value a business based on its ability to generate cash flow over the long term, and further buy at a price significantly below our estimate, we should stand to do reasonably well.

Basic Example

Let's assign a value on apples. If we were to place a bushel of Red Delicious apples on a scale and the reading stated 40 lbs, there isn't much to dispute except the accuracy of the scale. So 40 lbs is our fact. Next, if we looked at the price this variety sold for historically, we may come up with a number approximating $2/lb. In this case, then, we estimate the bushel of apples is worth $80 (40 lbs x $2/lb).

We now see a bushel on sale for $20, far below our estimate of value. The farmer tells us he is selling his crop at a big loss to raise emergency funds; he likes to trade stocks and it turns out he has sustained large losses in his margin account. Consequently, the brokerage requires him to inject more money to cover the margin call.

In other words, the farmer is a forced seller of the apples and is therefore selling at a price unrelated to the costs of producing them or what they reasonably *should* sell for based on demand.

After conducting a brief investigation, we buy the bushel for $20 on the last day of the sale. We ask common acquaintances of the farmer about his character, and inspect the bushel ourselves to ensure worms aren't crawling in-and-out of the apples. If we have truly bought the bushel at a 75% discount to its market value, we are in a position of limited downside. That is, if we missed something in our due diligence and the apples somehow turn out to be defective, our downside is $20; however, if everything is as appears, we can potentially sell the bushel for $60, which is still a 25% discount to fair value, and triple our money overnight. Alternatively, we can just enjoy consuming the apples with the satisfaction that each dollar travelled far with the purchase.

Price Travels to Value… Comparable to Buoyancy?

And now the critical question: If price is suppressed far below fair value, why should price ever be pulled towards value?

An analogy to value investing would be a ball under water that rises back to surface. This is Archimedes' principle, or the physical law of buoyancy at work. If the ball is pushed lower, its upside from that depressed point becomes even greater. With value investing, the water surface represents the fair price of an investment. Thus if other investors drive a stock price too low versus where it deserves to trade based on the company's earnings power, an opportunity to make a good profit has been created – as long as the valuation is ultimately correct. Instead of gravity, which is the force behind buoyancy, we have the force of capitalism in value investing: investment dollars should continually migrate to opportunities offering the best perceived trade-offs between risk and return.

Investor psychology can literally drive prices anywhere – far below or above value – in the near term, or maybe even for an extended period far exceeding the average investor's capacity to wait. Therefore, unlike buoyancy, where the time required for the ball to rise to surface is calculable within a reasonable margin of error, we cannot reliably know how much time is required for the price-value gap to close. And since value itself is a calculation that involves not only facts but also judgment, the low-high range for valuing any given company can be extremely wide.

Why is Value Investing Compelling if so Unreliable?

If anything, we have established that value investing does not favor precision. The value of a company cannot be calculated with pinpoint accuracy. Moreover, a stock's price can stay meaningfully below value forever because of investor psychology. So why is value investing a compelling philosophy if it is so imperfect in practice?

The value style resonates with a select crowd because it focuses on the knowable to determine the worth of stocks or just about any type of asset. Each share represents real, though fractional ownership in a company. Naturally, the value of each share is directly linked to the earnings of the company over time. If earnings per share doubles within six years, it's likely that the stock price will follow to at least some degree. What else can make more sense? Value investors prize independent thinking and arrive at conclusions based on logic, not emotion or instincts. Yes, like Spock. By having a long time horizon, we can take advantage of randomness and emotions that cause prices to detach far from value.

But perhaps just as important as the notion that price *should* converge with value is the defensive positioning created by locking in a price below value: the upside to downside implied in the range of outcomes becomes what we call asymmetric, meaning the range of outcomes is skewed toward success more than failure. All else being equal, a lower price increases our return and decreases our downside risk.

Sector Breakdown

Flagship		Mid-Large Cap	
Sector	**Weight**	**Sector**	**Weight**
Healthcare	22.2%	Healthcare	21.0%
Technology	13.0%	Packaged Food	12.8%
Packaged Food	11.2%	Financials	10.6%
Media/Broadband	10.2%	Consumer Diversified	10.6%
U.S. Real Estate	9.6%	Technology	9.9%
Specialty Chemicals	9.4%	Energy	8.2%
Energy	8.6%	Business Services	5.7%
Private Equity	8.5%	Private Equity	5.6%
Business Services	5.8%	Media/Broadband	4.8%
Cash	1.5%	U.S. Real Estate	4.5%
		Specialty Chemicals	4.1%
		Cash	2.3%

Value managers work to add alpha by finding ideas that are not fully appreciated by the markets. As the indexes remain elevated, the appeal for active management should increase, especially for managers whose mandates prioritize independent and contrarian thinking. Albeit the market has not been agreeing with Starvine's picks in the short run, we are only at the very beginning of the marathon.

Sincerely,

Steven Ko
Portfolio Manager

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